

REPORT OF EXAMINATION
OF THE
INSURANCE COMPANY OF THE WEST

AS OF
DECEMBER 31, 2005

Participating State
and Zone:

California

Filed December 22, 2006

TABLE OF CONTENTS

	<u>PAGE</u>
SCOPE OF EXAMINATION.....	1
COMPANY HISTORY	2
MANAGEMENT AND CONTROL:	2
Management Agreements	4
TERRITORY AND PLAN OF OPERATION	5
REINSURANCE:	6
Intercompany Pooling Agreement	6
Assumed.....	6
Ceded	6
Finite Transaction	11
ACCOUNTS AND RECORDS	14
FINANCIAL STATEMENTS:	15
Statement of Financial Condition as of December 31, 2005	16
Underwriting and Investment Exhibit for the Year Ended December 31, 2005.....	17
Reconciliation of Surplus as Regards Policyholders from December 31, 2001 through December 31, 2005.....	18
COMMENTS ON FINANCIAL STATEMENT ITEMS:.....	19
Common Stocks	19
Losses and Loss Adjustment Expenses	19
SUMMARY OF COMMENTS AND RECOMMENDATIONS:.....	20
Current Report of Examination.....	20
Previous Report of Examination.....	20
ACKNOWLEDGEMENT	21

Los Angeles, California
November 29, 2006

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition (EX4) Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Gary L. Smith
Secretary, Zone IV-Western
Director of Insurance
Department of Insurance, State of Idaho
Boise, Idaho

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Director and Commissioner:

Pursuant to your instructions, an examination was made of the

INSURANCE COMPANY OF THE WEST

(hereinafter also referred to as the Company) at its home office located at 11455 El Camino Real, San Diego, California 92130.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2001. This examination covers the period from January 1, 2002 through December 31, 2005. The examination was made pursuant to the National Association of Insurance Commissioners' (NAIC) plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2005, as deemed necessary under the circumstances.

The examination was conducted concurrently with the examination of the Company's wholly-owned subsidiary, Explorer Insurance Company.

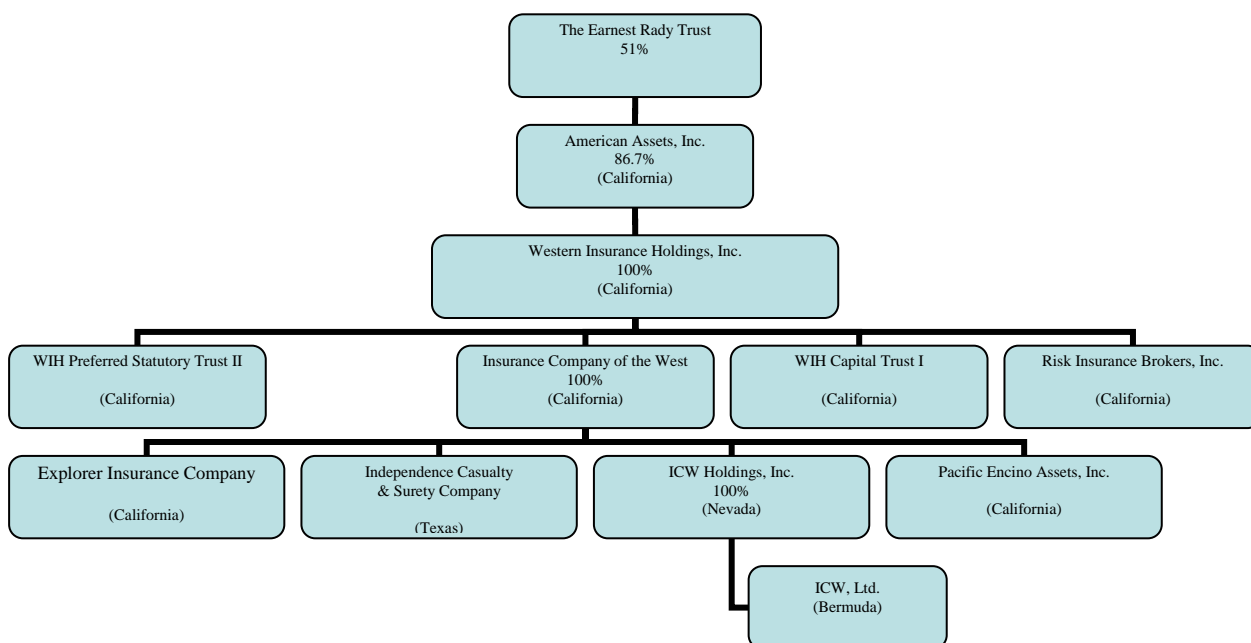
In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

COMPANY HISTORY

Effective July 3, 2002, the California Department of Insurance granted approval for Western Insurance Holdings, Inc. (parent organization) to contribute 1,925,000 shares of Westcorp, Inc. common stock to the Company. As a result of this contribution, the balance of the gross paid-in and contributed surplus account increased by \$58,077,250 to \$129,181,658.

MANAGEMENT AND CONTROL

Ultimate control of the Company is maintained by Ernest S. Rady and family members. The following organizational chart depicts the Company's relationship within the holding company system:



Management of the Company is vested in a ten-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2005 follows:

Directors

Name and Residence

Bernard M. Feldman
Del Mar, California

John L. Hannum
Ramona, California

Gene P. Irizarry
San Diego, California

Bruce N. Moore
San Diego, California

Principal Business Affiliation

Vice Chairman
Insurance Company of the West

Executive Vice President
Insurance Company of the West

Chief Operating Officer
Insurance Company of the West

Retired Insurance Executive

Name and ResidencePrincipal Business Affiliation

Kevin M. Prior
San Diego, California

President
Insurance Company of the West

Ernest S. Rady
La Jolla, California

Ultimate Controlling Person
Insurance Company of the West
and affiliates

Harry M. Rady
La Jolla, California

Investment Fund Manager

Charles E. Scribner
La Jolla, California

Retired Bank Executive

Fredrika Taubitz
San Diego, California

Retired Insurance Executive

Arne D. Wagner
Piedmont, California

Attorney, Calvo & Clark, LLP

Principal OfficersNameTitle

Kevin M. Prior
James W. Austin
Henry M. Freet

President
Secretary
Treasurer

Management Agreements

Tax Sharing Agreement: The Company and its affiliates are parties to a consolidated federal income tax agreement with the ultimate parent, American Assets, Inc. (AA). Allocation of taxes is based upon separate return calculations with current credit for net losses. Upon review, intercompany tax balances were found to be settled in accordance with the terms of the agreement.

Property Management Agreement: AA manages the Company's offices in Del Mar and Valencia, California. During 2002, 2003, 2004 and 2005, AA received \$16,025, \$23,190, \$33,065 and \$29,200 respectively, as compensation under the terms of this agreement.

Investment Management Agreement: In accordance with an Investment Management Agreement executed March 1, 1992, AA began managing the Company's investment portfolio at a cost of \$50,000 per quarter. The services performed by AA are subject to the direction and control of the Company's Investment Committee.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2005, the Company was licensed to transact multiple lines of property and casualty insurance in the following 42 states:

Alabama	Indiana	Nebraska	South Dakota
Alaska	Iowa	Nevada	Tennessee
Arizona	Kansas	New Mexico	Texas
Arkansas	Kentucky	North Carolina	Utah
California	Louisiana	North Dakota	Virginia
Colorado	Maryland	Ohio	Washington
Florida	Michigan	Oklahoma	West Virginia
Georgia	Minnesota	Oregon	Wisconsin
Hawaii	Mississippi	Pennsylvania	Wyoming
Idaho	Missouri	Rhode Island	
Illinois	Montana	South Carolina	

Underwriting emphasis is placed on workers' compensation, earthquake, and surety coverages. During 2005, the Company wrote approximately \$183 million of direct premiums. Of the direct premiums written, over 81% pertained to California risks. Business is produced through approximately 700 independent agents.

Branch offices are maintained in Fresno, Sacramento, Tustin and Walnut Creek, California; Albuquerque, New Mexico; Boise, Idaho; Chicago, Illinois; Dallas, Houston, and San Antonio,

Texas; Denver, Colorado; Las Vegas, Nevada; Phoenix, Arizona; Portland, Oregon; Salt Lake City, Utah; and Seattle, Washington.

REINSURANCE

Intercompany Pooling Agreement

Under the terms of an Intercompany Pooling Agreement, the Company's wholly-owned subsidiaries, Explorer Insurance Company (Explorer) and Independence Casualty and Surety Company (Independence), cede 100% of their written premiums to the Company. The Company, in turn, retrocedes a 15% and 1.5% pro rata portion of premiums, losses, and expenses to Explorer and Independence, respectively.

Assumed

During the period under review, assumed premiums have been declining. For the year 2005, the Company booked approximately \$3.2 million of assumed business, which related to industry market loss warranty and excess of loss catastrophe business. With respect to the year 2005, the reported loss ratio on assumed business exceeded 300%. The Company's adverse loss experience stemmed primarily from the impact of Hurricane Katrina.

Ceded

The largest net amount retained in any one risk is \$8.4 million. Excess of loss reinsurance provides \$49.5 million excess of \$500,000 for property coverages; \$14.0 million excess of \$1.0 million for workers' compensation; and \$8.0 million excess of \$2.0 million for surety. A 55% quota share agreement, effective October 1, 2005, provides additional coverage against difference in conditions earthquake losses up to \$114 million per occurrence. Catastrophe reinsurance provides 100% of \$376.4 excess of \$20 million coverage on property business and 99.6% of \$166.5 million excess of \$3.5 million on wind and hail business. The purchase of other non-

treaty catastrophe reinsurance provides additional coverage of \$60 million for California earthquake and \$3 million for Florida windstorm risks.

The following depicts in schedule form the major ceded reinsurance contracts in-force as of December 31, 2005:

<u>Type of Contract</u>	<u>Reinsurer</u>	<u>Company Retention</u>	<u>Reinsurers' Limits</u>
<u>Property:</u>			
First property excess-per risk	20.0% Odyssey America Reins Corp 23.5% Liberty Mutual Ins Co 24.0% Underwriters at Lloyd' 32.5% various reinsurers	\$500,000	\$500,000 excess of \$500,000
Second property excess-per risk	13.0% Odyssey America Reins Corp 15.0% Underwriters at Lloyd's 72.0% various reinsurers	\$1 million	\$4 million excess of \$1 million
Third property excess-per risk	15.0% R + V Versicherung AG 38.0% Underwriters at Lloyd's 52.0% various reinsurers	\$5 million	\$5 million excess of \$5 million
Fourth property excess-per risk	15.0% R + V Versicherung AG 60.0% Underwriters at Lloyd's 25.0% various reinsurers	\$10 million	\$10 million excess of \$10 million
First property catastrophe. – per occurrence (wind only)	25.0% Davinci Re 25.0% Renaissance Re 50.0% various reinsurers	\$3.5 million	87.5% of \$4 million excess of \$3.5 million
Second property catastrophe. – per occurrence (wind only)	48.5% Underwriters at Lloyd's 20.0% AXA Re 31.5% various reinsurers	\$7.5 million	\$22.5 million excess of \$7.5 million
Third property catastrophe – per occurrence (Wind)	17.5% Underwriters at Lloyd's 20.0% AXA Re 62.5% various reinsurers	\$30 million	\$10 million excess of \$30 million
Third property catastrophe – per Occurrence (non-Wind)	100% Swiss Re America	\$30 million	\$10 million excess of \$30 million
Fourth property	61.25% Underwriters at Lloyd's	\$40 million	\$10 million excess of

<u>Type of Contract</u>	<u>Reinsurer</u>		<u>Company Retention</u>	<u>Reinsurers' Limits</u>
catastrophe – per occurrence combined	13.75% 25.00%	Glacier Re various reinsurers		\$40 million
Fifth property catastrophe – per occurrence (combined)	54.5% 44.5%	Underwriters at Lloyd's various reinsurers	\$50 million	\$40 million excess of \$50 million
Sixth property catastrophe – per occurrence (combined)	57.0% 10.5% 32.5%	Underwriters at Lloyd's Liberty Syndicate Services various reinsurers	\$90 million	\$40 million excess of \$90 million
Seventh property catastrophe – per occurrence (combined)	32.25% 17.50% 50.25%	Underwriters at Lloyd's Glacier Re various reinsurers	\$130 million	\$40 million excess of \$130 million
Eighth property catastrophe – per occurrence (non-wind)	32.5% 14.0% 50.2%	Underwriters at Lloyd's Liberty Syndicate Services various reinsurers	\$170 million	96.7% \$75 million excess of \$170 million
Ninth property catastrophe. – per occurrence (non-wind)	40.5% 10.0% 44.4%	Underwriters at Lloyd's Hannover Re various reinsurers	\$245 million	94.9% of \$120 million excess of \$245 million
Tenth property catastrophe – per occurrence (non-wind)	73.75% 26.25%	Tokio Millenium various reinsurers	\$365 million	\$40 million excess of \$365 million
Property Catastrophe. – per occurrence (non wind)	100%	ICW, Ltd.	\$15 million	\$10 million excess of \$15 million
DIC Quota Share (55%)	40% 40%	Arch Reinsurance Co Transatlantic Re		55% quota share, 80% placed.
<u>Workers' Compensation:</u>				

<u>Type of Contract</u>	<u>Reinsurer</u>		<u>Company Retention</u>	<u>Reinsurers' Limits</u>
Workers' Compensation excess of loss	100%	ICW Ltd	\$1 million	\$4 million excess of \$1 million
First Workers' Compensation excess-per occurrence	25% 61% 14%	Danish Re various reinsurers Lloyds Syndicates	\$5 million	\$5 million excess of \$5 million
Second Workers' Compensation excess-per occurrence	30.0% 25.0% 22.5%	Renaissance Re Danish Re various reinsurers	\$10 million	77.5% of \$5 million excess of \$10 million
Second Workers' Compensation excess – per occurrence (separate contract with ICW, Ltd.)	22.5%	ICW, Ltd.	\$10 million	22.5% of \$5 million excess of \$10 million
<u>Specialty Programs:</u>				
Boiler and Machinery Coverage	100%	Hartford Steam Boiler Inspection and Insurance Company		1 st dollar coverage to \$25 million
Property Catastrophe Industry Loss Warranty -excess of loss (coastal states wind)	100%	PXRE Reinsurance	\$25,000	\$5 million excess of \$25 million – triggered by a \$5 thru \$10 billion industry loss
Industry Loss Warranty Catastrophe -excess of loss (California earthquake)	100%	Tokio Millenium	\$250,000	\$25 million excess of \$250,000 – triggered by a \$35 billion industry loss
Property Catastrophe	66.67% 33.33%	Muenchener Re Lloyds Syndicate #626	\$250,000	\$15 million excess of \$250,000 – triggered

<u>Type of Contract</u>	<u>Reinsurer</u>	<u>Company Retention</u>	<u>Reinsurers' Limits</u>
Industry Loss Warranty -excess of loss (California Earthquake)			by a \$30 billion industry loss
Industry Loss Warranty Catastrophe -excess of loss (California Earthquake)	100% various reinsurers	\$25,000	\$45 million excess of \$25,000 – triggered by a \$40 billion industry loss
	100% Allianz Risk Transfer	\$25,000	\$2 million excess of \$25,000 - triggered by a \$5 billion industry loss
Industry Loss Warranty Catastrophe -excess of loss (Florida only) Industry Loss Warranty Catastrophe -excess of loss (exclude California and Florida)	100% Lloyds Syndicate	\$25,000	\$5 million excess of \$25,000 – triggered by a \$6 billion industry loss
Industry Loss Warranty Catastrophe -excess of loss (Florida Only)	100% Allianz Risk Transfer	\$25,000	\$3 million excess of \$25,000 – triggered by a \$3 thru \$5 billion industry loss
Industry Loss Warranty Catastrophe -excess of loss (Florida Only)	100% Axis Specialty Limited	\$25,000	\$5 million excess of \$25,000 – triggered by a \$6 thru \$10 billion industry loss

As noted in the previous table, the reinsurance program includes the following coverages provided by the Company's captive offshore reinsurer, ICW Ltd: property catastrophe excess of loss - \$10 million excess of \$15 million, workers' compensation excess of loss - \$4 million excess of \$1 million, and workers' compensation catastrophe excess of loss - 22.5% of \$5 million excess of \$10 million.

Finite Transaction

Effective July 1, 2000, the Company entered into a multi-year aggregate excess of loss reinsurance agreement. Execution of the stop loss agreement took place approximately nine months after the effective date. The agreement involved multiple layers of coverage attaching at different loss ratios with the Company's retention stipulated as a percentage of subject net earned premium income. In April 2004, the Company and the reinsurer commuted this agreement under the terms of a Commutation and Release Agreement.

The risk transfer analysis supporting the accounting for the transaction as reinsurance was prepared by the intermediary for the agreement. Although the Company's certified public accounting (CPA) firm reviewed the initial accounting for the transaction without exception, the Company did not provide documentation giving evidence of the CPA's risk transfer analysis.

With consideration given to (1) a review of the inherent contract provisions, (2) the accounting for the agreement, (3) representations offered by the reinsurer, and (4) a review conducted by a Casualty Actuary from the California Department of Insurance, it has been concluded that the transaction in question was improperly accounted for as reinsurance. The following is a summary of the principal attributes of the agreement:

- The agreement incorporated the utilization of a funds held account. Accordingly, ceded premiums were not transmitted to the reinsurer; instead premiums ceded to the reinsurer were credited to the Company administered funds held account.
- Although the Company was contractually obligated to report to the reinsurer on a quarterly basis all changes impacting the funds held account balance (including ultimate net losses outstanding), compliance with this requirement could not be confirmed.
- Notwithstanding the margin payment of \$575,000 per year to the reinsurer, (improperly recorded as deposit premiums), there was no exchange of money during the period covered by the agreement through the execution of the commutation and release agreement.
- The reinsurer's profit potential was limited to the margin payments.

- The commutation clause included provisions that indicated the likelihood that the contract would be commuted.

The following schedule summarizes the accounting for the transaction: (000 omitted)

Year	Ceded Written Premiums	Ceded Earned Premiums	Ceded IBNR Loss Reserves (Incremental)	Ceded Paid Losses	Ceding Commission	Investment Expense (Accrual of Interest on Funds Held Balance)	Cash Paid to Reinsurer	Enhancement of Underwriting Income	Effect on Net Income (Loss)
2000	\$(15,000)	\$(7,500)	\$(7,500)		\$(4,500)	\$ 1,526	\$ 575	\$ 4,500	\$ 2,974
2001	(15,000)	(15,000)	(15,000)		(4,500)	4,756	575	4,500	(255)
2002	(15,000)	(15,000)	(6,140)	\$ (8,860)	(4,500)	8,235	575	4,500	(3,735)
2003		(7,500)	4,640	(21,141)		9,752		9,001	(752)
2004			(1,963)	(1,343)		3,263		3,306	43
Commutation Entries			25,963	(25,963)					
Totals	\$(45,000)	\$(45,000)	\$ 0	\$(57,307)	\$(13,500)	\$27,532	\$1,725	\$25,807	\$(1,725)

Contrary to the customary practice of utilizing quantifiable experience as the basis for the establishment of ceded incurred but not reported (IBNR) losses, the Company maintained the practice of accruing, to its benefit, ceded IBNR losses of \$1,250,000 a month to force a reported 100% loss ratio.

The \$27.6 million of booked accrued interest is equal to the sum of the \$25.9 million of ceded IBNR loss reserves plus the \$1.7 million of cash paid to the reinsurer. The recognition of the cash paid to the reinsurer as an investment expense, rather than an underwriting charge, is inconsistent with customary reinsurance accounting practices.

Implementation of the agreement resulted in (1) the shifting of \$25.9 million of underwriting losses (ceded IBNR loss reserves) to investment expenses and (2) the reduction of net income by \$1.7 million, which represents the cash paid to the reinsurer.

It was also noted that from the onset of the transaction, the reinsurer neither recognized the cession of premiums from the Company nor any assumed IBNR reinsurance payable in its Annual Statements with respect to this agreement. By written confirmation, the reinsurer indicated that the agreement lacked sufficient risk transfer to be accounted for as reinsurance under the

provisions of the Statement of Statutory Accounting Principles (SSAP) No. 62. Accordingly, the reinsurer indicated that it accounted for the agreement as a deposit.

Upon review of the risk transfer analysis, a Casualty Actuary from the California Department of Insurance (CDI) concurred with the reinsurer's assessment that the contract failed to pass the risk transfer requirements of SSAP No. 62.

The CDI Actuary has concluded that absent a loss ratio exceeding 84% the reinsurer would not have sustained a loss. During the ten year period prior to the effective year of the agreement, the Company's reported loss ratio exceeded 84% only during 1990. It was further noted that during the three years preceding the agreement (1997, 1998 and 1999), the Company reported loss ratios of 57.1%, 52.3% and 55.0%, respectively.

With consideration given to the above referenced loss experience, it appears that only a catastrophic loss could have triggered an actual recoverable (losses exceeding the funds held account balance including interest thereon) from the reinsurer. As previously noted, the Company's reinsurance program included catastrophe protection under the terms of other reinsurance agreements.

It is the Company's opinion that the accident year aggregate excess of loss treaty did meet the requirements of SSAP 62 for reinsurance accounting. It based that opinion on the analysis prepared by the reinsurance intermediaries involved in the transaction and the opinion of its CPAs, although, as previously noted, no evidence of a risk transfer analysis was provided by the CPAs or the Company.

The Company believes that although this treaty may have contained some attributes of finite reinsurance, it did provide another layer of coverage, including catastrophe (CAT) protection. According to the Company, while remote, there was a chance that its deteriorating workers' compensation and casualty experience could have triggered recoveries from this treaty. In addition, according to the Company, the coverage would have been easily triggered in a one-in-ten-year CAT event. It should be noted that during the examination the Company provided no

documentation to support its contention that the treaty provided another layer of catastrophic protection and would have been triggered in a one-in-ten- year CAT event. In addition, the Company's response to the examination report failed to address the reinsurer's conclusion that the agreement lacked sufficient risk transfer to be accounted for as reinsurance under SSAP No. 62.

Based on the above, it is recommended that the Company perform adequate risk transfer analysis on all future reinsurance agreements and account for the agreements in accordance with SSAP No. 62.

ACCOUNTS AND RECORDS

A limited review of the general controls over the Company's electronic data processing activities was conducted. The Company has developed a formal written disaster recovery plan for its electronic data processing, which is currently being updated. Periodic tests, however, have not been performed to ensure its effectiveness. This deficiency was also noted in the previous examination. If a loss of electronic data processing capabilities were to occur, it could be very costly and disruptive to the Company and its policyholders. It is once again recommended that the disaster recovery plan be tested at the earliest possible time.

In addressing the need for an effective disaster recovery plan, the Company engaged SunGard Availability Services (SunGard) to conduct a Business Impact and Strategy Analysis for twenty-five of its key business units during the months of January 2006 to April 2006. The Company is currently assessing SunGard's recommendations regarding the implementation, maintenance and testing of such a recovery plan. The Company expects to complete its assessment later in 2006, with implementation taking place in 2007.

The Company has also hired a business resiliency manager to design, implement and maintain a comprehensive disaster recovery plan.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2005

Underwriting and Investment Exhibit for the Year Ended December 31, 2005

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2005

Statement of Financial Condition
as of December 31, 2005

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$134,739,352	\$	\$134,739,352	
Preferred stocks	1,053,662	183,962	869,700	
Common stocks	488,289,529		488,289,529	(1)
Mortgage loans on real estate	6,531,040		6,531,040	
Cash and short-term investments	53,508,264		53,508,264	
Other invested assets	6,383,858		6,383,858	
Investment income due and accrued	1,797,109		1,797,109	
Uncollected premiums and agents' balance in the course of collection	19,153,835		19,153,835	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	26,230,449		26,230,449	
Amounts recoverable from reinsurers	6,160,144		6,160,144	
Guaranty funds receivable or on deposit	46,591		46,591	
Electronic data processing equipment and software	3,482,441	2,790,166	692,275	
Furniture and equipment	1,630,530	1,598,096	32,434	
Aggregate write-ins for other than invested assets	<u>1,501,166</u>	<u>796,909</u>	<u>704,257</u>	
Total assets	<u>\$750,507,970</u>	<u>\$5,369,133</u>	<u>\$ 745,138,837</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$146,787,406	(2)
Loss adjustment expenses			40,550,105	(2)
Commissions payable, contingent commissions and other similar charges			1,623,303	
Other expenses			13,159,403	
Taxes, licenses and fees			2,004,601	
Current federal and foreign income taxes			1,041,409	
Net deferred tax liability			67,239,924	
Unearned premiums			73,593,342	
Ceded reinsurance premiums payable			7,558,731	
Funds held by company under reinsurance treaties			6,565,093	
Amounts withheld or retained by company for account of others			1,086,003	
Remittances and items not allocated			14,551	
Provision for reinsurance			4,837,086	
Drafts outstanding			695,345	
Payable to parent, subsidiaries and affiliates			2,877,479	
Payable for securities			398,442	
Aggregate write-ins for liabilities			<u>10,494,494</u>	
Total liabilities			380,526,717	
Common capital stock		\$		
Gross paid-in and contributed surplus		129,181,65		
Unassigned funds (surplus)		<u>232,430,46</u>		
Surplus as regards policyholders			<u>364,612,120</u>	
Total liabilities, surplus and other funds			<u>\$745,138,837</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2005

Statement of Income

Underwriting Income

Premiums earned		\$200,030,984
Deductions:		
Losses incurred	\$89,816,575	
Loss expense incurred	30,836,675	
Other underwriting expenses incurred	<u>67,260,589</u>	
Total underwriting deductions		<u>187,913,839</u>
Net underwriting gain		12,117,145

Investment Income

Net investment income earned	\$17,657,935	
Net realized capital losses	<u>(1,143,813)</u>	
Net investment gain		16,514,122

Other Income

Net gain from agents' balances or premium balances charged off	\$ 1,100,760	
Finance and service charges not included in premiums	2,362,428	
Aggregate write-ins for miscellaneous losses	<u>(1,432,405)</u>	
Total other income		<u>2,030,783</u>
Net income before dividends to policyholders and before federal income taxes		30,662,050
Dividends to policyholders		663,080
Federal income taxes incurred		<u>7,190,327</u>
Net income		<u>\$ 22,808,643</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2004		\$ 293,453,466
Net income	\$ 22,808,643	
Change in net unrealized capital gains	72,673,943	
Change in net deferred income tax	4,008,405	
Change in nonadmitted assets	762,489	
Change in provision for reinsurance	3,534,434	
Dividends to stockholders	(2,100,000)	
Aggregate write-ins for losses in surplus	<u>(30,529,260)</u>	
Change in surplus as regards policyholders		<u>71,158,654</u>
Surplus as regards policyholders, December 31, 2005		<u>\$ 364,612,120</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2005

Surplus as regards policyholders, December 31, 2001, per Examination			\$123,410,770
	Gain in Surplus	Loss in Surplus	
Net income	\$ 88,280,146	\$	
Change in net unrealized capital gains	149,867,049		
Change in net deferred income tax		3,778,116	
Change in nonadmitted assets	1,285,231		
Change in provision for reinsurance	1,311,966		
Surplus adjustments: Paid-in	58,077,250		
Dividends to stockholders		2,100,000	
Aggregate write-ins for losses in surplus	<u> </u>	<u>51,742,176</u>	
Totals	<u>\$298,821,642</u>	<u>\$57,620,292</u>	
Net increase in surplus as regards policyholders			<u>241,201,350</u>
Surplus as regards policyholders, December 31, 2005, per Examination			<u>\$364,612,120</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Common Stocks

On July 3, 2002, the California Department of Insurance (CDI) approved the contribution from Western Insurance Holdings, Inc. (parent organization) of 1,925,000 shares of Westcorp, Inc. (Westcorp) common stock. As noted in the 2002 Annual Statement, the cumulative book/adjusted carrying value of the Company's Westcorp holdings (3.8 million shares) totaled \$58,962,931 or 32% of the Company's reported surplus. With the increase of the market value of Westcorp common stock, the book/adjusted carrying value of Westcorp common stock increased to 55% of reported surplus at year-end 2005. As of the date of this examination, the Company was not in compliance with California Insurance Code (CIC) Section 1215.1, which limits an insurer's investment in the common stock of an affiliate from representing more than 50% of its surplus.

During September 2005, the Company's affiliates, Westcorp and WFS Financial, Inc. entered into a stock for stock merger agreement with Wachovia Corporation (non-affiliate). Effective March 1, 2006 the merger was completed whereby the Company received 4.8 million shares of Wachovia Corporation in exchange for its 3.8 million shares of Westcorp, Inc. Upon completion of the merger, the Company's investment valuation in Wachovia Corporation common stock constituted approximately 75% of reported surplus.

CIC Section 1215.1 (e) provides that if an insurer ceases to control a subsidiary, it has three years to achieve compliance with the investment restrictions mandated by any other code section. Accordingly, at the end of the three-year grace period the Company will be subject to CIC Section 1198 which provides that an individual excess funds investment shall not constitute more than 25% of an insurer's surplus.

In response to the above findings, the Company sold four million shares of its Wachovia Corp. common stock in October 2006 to its affiliate, American Assets, Inc. The sale of the stock was approved by the CDI.

(2) Losses and Loss Adjustment Expenses

Based upon a review conducted by a Casualty Actuary from the CDI, the Company's reserves for losses and loss adjustment expenses as of December 31, 2005 were found to be reasonably stated.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Reinsurance – Finite Transaction (Page 11): It is recommended that the Company perform adequate risk transfer analysis on all future reinsurance agreements and account for the agreements in accordance with SSAP No. 62.

Accounts and Records (Page 14): It is recommended that the disaster recovery plan be tested at the earliest possible time. This deficiency was also noted in the previous examination. In response to this recommendation, the Company is currently assessing its outside consultant's recommendations regarding the implementation, maintenance and testing of its disaster recovery plan. The Company expects to complete its assessment later in 2006, with implementation taking place in 2007.

Previous Report of Examination

Accounts and Records (Page 10): It was recommended that the Company's disaster recovery plan be tested at the earliest possible time. Although the Company has not fully complied with this recommendation and as noted previously, it is currently assessing an outside consultant's recommendations regarding the implementation, maintenance and testing of its disaster recovery plan.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

_____/S/_____
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